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Financial Digest
Economic Commentary, Selected Financial Data, and Business Indicators

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Correcting The Trade Deficit . . .

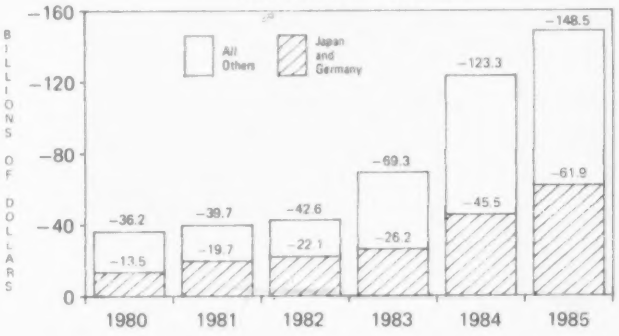
The sizable imbalances in the external account positions of the three largest industrial nations, the United States, Japan and Germany, are now viewed as one of the more serious problems facing the world economy. While the U.S. has seen its trade deficit soar well into 12-digit territory, the Japanese and Germans have experienced the opposite: namely, marked increases in their surpluses. One response to this problem has been a year-long effort by the United States to guide the dollar lower in the foreign exchange markets. Another, of more recent vintage, has been a rising chorus of calls for faster economic growth in Japan and Germany—presumably enhancing U.S. export opportunities and trimming substantially the overall red-ink total.

While this approach appears to have a good deal of merit, a word of caution is in order. The U.S. trade deficit is now too large, and the proportion of U.S. exports absorbed by these countries is too small, for faster growth in Japan and Germany alone to cure what ails the trade balance. Only by diminishing further the price attractiveness of imports, while enhancing that of exports, will more significant near-term improvements occur—a remedy requiring an even weaker dollar in the foreign exchange markets.

The U.S. Administration had hoped that the better than 30 percent decline in the trade-weighted value of the dollar from its peak of February 1985 would help to narrow our trade deficit. This has not yet happened. In fact, the U.S. deficit has gotten worse and is expected to exceed last year's record shortfall of $148.5 billion by at least ten percent. This development has led the Administration to seek another avenue in finding a solution to the widening trade deficit.

By urging Japan and Germany to adopt more stimulative fiscal and monetary policies, the hope is that the resulting faster growth will prompt stepped-up demand for U.S.-produced goods. In this regard, Japan's bilateral surplus is of particular concern; exports to the United States rose from three percent to nearly five percent of Japanese GNP between 1980 and 1985, and its surplus with this country is expected to approach $60 billion this year, almost three times the $21.7 billion surplus it ran with the U.S. in 1983. The trade deficit with Germany, although far smaller, still totaled a shade more than $12 billion last year, and could hit $15 billion this year. Together they now account for better than 40 percent of the global U.S. trade deficit (see chart).

U.S. TRADE DEFICIT:
GLOBAL AND WITH JAPAN AND GERMANY
(Exports f.a.s./Imports c.i.f.)



. . . Requires More Than Faster Growth . . .

Japan's and Germany's growing trade surpluses and low rates of inflation would seem to give them quite a bit of leeway to stimulate their domestic economies. In fact, on the surface, the emergence of such large surpluses might indicate that domestic demand is relatively weak. In the case of Germany, for example, inflation-adjusted domestic demand was not much larger in 1985 than it was in 1981, expanding at an anemic 0.1 percent average annual rate during the period. But, so far, both countries have shown great reluctance to heed U.S. advice. Japanese and German officials continue to insist that falling oil prices, low inflation and declining interest rates will boost domestic demand all by themselves. However, even if Japan and Germany did grow rapidly, the favorable impact on the U.S. trade deficit may be limited.

Take, for example, Japan, which now accounts for some 12 percent of U.S. exports. Exports to that country have been growing at an average annual rate of about five percent since the beginning of the decade, and totaled $22½ billion last year. Thus, even if the rate of export growth was to double in

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coming years—reaching double-digit territory—it would add no more than $2½ billion to the present level of U.S. export sales in the first year, and an additional $13 billion to exports by the fifth year. To be sure, while $13 billion is not an insignificant sum, if imports remained unchanged, it would trim today's bilateral trade deficit by only one-fifth by the early 1990s.

So, too, in the case of Germany, which accounts for an even smaller proportion of global U.S. exports. It purchased four percent, or $9 billion of U.S. goods in 1985. For one thing, even at its high point, Germany never absorbed more than five percent of total U.S. exports. This was in 1980, just about the last time that Germany was attempting to act as a locomotive for Europe's growth. If this peak proportion prevailed today, it would add only $2 billion to U.S. exports, trimming the bilateral deficit with Germany by some 15 percent.

. . . In Japan And Germany Alone

For another, although U.S. exports to Germany are 17 percent below their 1980 peak, a good chunk of this decline—about a quarter—was accounted for by a dip in shipments of agricultural commodities. While faster growth in Germany may bolster demand for U.S. manufactured goods, it is questionable that it would lead to similar increases in sales of such commodities as tobacco and soybeans. However, even if it did, perhaps more important is this: Had U.S. exports increased by 17 percent since

Selected Federal Reserve Data

(Averages of Daily Figures—Billions of Dollars)

	Week Ending	$ Change Since Week Ago	$ Change Since Year Ago
Reserve Bank Credit	8/27/86		
U.S. Gov'ts and Agencies Owned Outright & RPs	193.642	+ .557	+16.935
Loans to Depository Inst.	.887	− .046	− .209
Float	.752	+ .303	+ .604
Total Reserve Bank Credit	210.711	+ .749	+20.824
Treasury Deposits with Federal Reserve Banks	3.284	− .170	+ .848
Currency in Circulation	200.612	− .672	+13.367
Gov'ts held for Foreign Acct. by F.R. Banks (End-of-Week)	155.291	− .814	+31.232
	8/27/86		
Member Bank Reserves:			
Total Reserves Held	50.491	− .016	+ 7.613
Excess (Deficiency)	.790	+ .208	− .160
Net Free Reserves	.395	+ .199	− .077

Monetary Aggregates †		% Change Since Three Months Ago*	% Change Since Year Ago
M1 (8/18/86)	688.1	+ 17.1‡	+ 13.3‡
M2 (July '86)	2,698.5	+ 11.6	+ 8.1
M3 (July '86)	3,371.5	+ 9.5	+ 8.3
Domestic Nonfinancial Debt (1st Q'86)	7,033.5	+ 8.7	+ 14.2

†Seasonally adjusted.

* Seasonally adjusted annual rate.
‡ Four-week moving average.

New York Money Market

Offering Rates 8/29/86	3 Months	6 Months	1 Year
‡ U.S. Treasury Bills	5.18%	5.18%	5.24%
* Federal Agencies	5.29	5.28	5.28
* Municipal Notes—High Grade (46% Taxable Equivalent)	6.94	7.87	8.15
Negotiable Time CDs Manufacturers Hanover	Rates By Arrangement		
* Secondary Market—Prime	5.45	5.45	5.55

‡ Finance Company Paper—Prime

5- 14 days	5.40%
15- 29 days	5.40
30- 59 days	5.35
60- 89 days	5.30
90-179 days	5.30
180-239 days	5.25
240-270 days	5.25

‡* Bankers' Acceptances

Sep.	5.52%
Oct.	5.42
Nov.	5.40
Dec.	5.36
Jan.	5.33
Feb.	5.30

‡ Industrial Paper—Prime

30- 89 days	5.39%
90-120 days	5.32

† Federal Funds Effective Rate 5.75%

‡ Discount basis. * Subject to availability. † Estimated.

Selected Business Indicators

(All Dollar Figures in Billions)

	Latest Period or End of Period		Previous Period	Year Ago Period
Gross National Product (Current Dollars)*	2nd Q'86	$ 4,180r	$ 4,149	$ 3,965
Gross National Product (1982 Dollars)*	2nd Q'86	$ 3,662r	$ 3,656	$ 3,568
Percent Change, Annual Rate	2nd Q'86	0.6r	3.8	2.3
Change in Consumer Prices*	Jul '86n	0.0%	6.0%	2.4%
Change in Producer Prices*	Jul '86	− 4.8%	0.0%	2.4%
Civilian Employment (Thousands of Persons)†	Jul '86	109,882	109,673	106,871
Unemployment as % of Civilian Labor Force†	Jul '86	6.9%	7.1%	7.3%
Personal Income*	Jul '86n	$ 3,502	$ 3,487r	$ 3,315
Leading Indicators Composite Index (1967=100)†	Jul '86n	179.4	177.4r	169.2
Industrial Production Index (1977=100) †	Jul '86	124.1	124.2	124.1
Net Change in Consumer Installment Credit †	Jun '86	$ 5.07	$ 6.46	$ 4.39
U.S. Merchandise Trade Balance	Jul '86n	−$ 18.04	−$ 13.25	−$ 13.58
Plant and Equipment Expenditures*	3rd Q'86	$388.87(a)	$387.42(a)	$388.90
Private Housing Starts (Thousands of Units)*	Jul '86n	1,818	1,852r	1,673
New Construction Expenditures*	Jun '86	$ 375.1	$ 374.9	$ 352.9
Total Business Inventories †	Jun '86	$ 589.0	$ 586.7	$ 580.1
Total Business Sales †	Jun '86	$ 423.6	$ 421.6	$ 418.2

*Seasonally adjusted annual rate. †Seasonally adjusted. n-Newly reported figure. r-Revised. a-Anticipated.

1980, rather than decreased by this amount, the results would not be all that much different—sales to Germany would be some $4 billion greater, and the global trade deficit a paltry 2½ percent smaller.

On the import side, in contrast, the American appetite for foreign products has not abated despite the fall in the value of the dollar. In many cases, Japanese and German competitors have held onto market share by cutting into profit margins. In other instances, there is little or no domestic competition as in the case of German luxury cars and Japanese electronic products. Finally, the dependability, reliability and quality of these products are key selling points. Thus, even under the most optimistic of circumstances, more rapid growth in Japan and Germany alone will not significantly reduce our bilateral deficits with these nations—given the hefty U.S. appetite for their products, and the limited potential for expanding exports to them quickly.

This means that additional exchange rate changes may be necessary if the trade deficit is to stabilize, and then narrow. While further dollar depreciation is no panacea by itself, it will certainly diminish the attractiveness of imports, giving longer-run solutions time to work. For over time, stronger growth in Japan and Germany, the lowering of additional barriers worldwide to market entry, and a further receding of the liquidity problems of Latin America will create a favorable climate for U.S. exporters to take full advantage of the fall of the dollar. H

Short Term Paper Outstanding

(Millions of Dollars)

	Latest Week	Change Since Week Ago	Change Since Year Ago
Time Deposits of $100,000 or more Weekly Reporting Banks			
Nationwide (8/13/86)	154,290	– 48	– 1,429
New York City (8/20/86)	33,374	+ 696	+ 849
Commercial Paper (8/20/86)	322,179	+ 3,014	+50,168

Bank Loans

(Millions of Dollars)

Commercial and Industrial Loans

Weekly Reporting Large Commercial Banks	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (8/13/86)	256,312	– 1,693	+ 2,830
New York City (8/20/86)	55,934	– 329	– 3,836

Total Loans and Leases Gross Adjusted

	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (8/13/86)	737,951	– 1,257	+ 54,551
New York City (8/20/86)	155,159	– 1,140	+ 1,975

Financial Markets

	Friday 8/29/86	Change Since Week Ago	Change Since Year Ago
U.S. Governments, Closing Yields:			
90-Day Bills†	5.17%	– .31	– 2.19
180-Day Bills†	5.19	– .45	– 2.48
Longest Bills†	5.24	– .50	– 2.77
Recent Issues:			
6⅛s 8/31/88 (When Issued)	5.84	– .26	
7¼s 6/15/90	6.32	– .18	
7⅜s 5/15/96	6.92	– .14	
7¼s 5/15/16	7.20	– .07	
Municipals:			
Bond Buyer–20 Bond Index* (8/28/86)	6.93%	– .40	– 2.16
Blue List Total ($ Million)	$1,632	–$ 636	– $ 147
30-Day Visible Supply ($ Million)	$1,008	–$2,174	– $2,508
Total	$2,640	–$2,810	– $2,655
Corporates:			
Moody's Aa Composite (8/28/86)	9.17%	– .06	– 2.13
30-Day Visible Supply ($ Million)	$1,231	–$ 990	– $1,409
Stocks:			
Dow-Jones Averages:			
Industrials	1,898.34	+ 10.54	+ 564.33
Transportation	772.13	+ 10.38	+ 81.47
Utilities	219.15	+ 1.76	+ 59.48
65 Stocks	736.37	+ 5.91	+ 182.00
N.Y.S.E. Composite Index	145.32	+ 1.44	+ 35.93
N.Y.S.E. Avg. Daily Vol. for Week (000's)	131,102	+ 4,690	+ 49,394

* 46% Taxable equivalent 12.83%.

† Bond equivalent.

International Rates

EURODOLLAR DEPOSIT RATES (bid)	Friday 8/29/86	Week Ago
Overnight	5.69%	5.86%
1 month	5.75	5.86
3 month	5.56	5.86
6 month	5.56	5.81
1 year	5.62	5.94
EURODOLLAR BONDS		
Average Yield		
Medium Term (5 to 7 yrs.)	7.15%	7.22%
Long Term (7 to 15 yrs.)	7.85	7.83

FOREIGN EXCHANGE SPOT RATES

New York Opening (8/29/86)	U.S. $ Equivalent	Currency Per U.S. $
Belgium	.02352	42.51
Canada	.7172	1.3943
Denmark	.1293	7.7350
France	.1486	6.7275
Germany	.4873	2.0520
Italy	.0007062	1416.00
Japan	.006417	155.83
Mexico	.001421	703.50
Netherlands	.4317	2.3165
Switzerland	.6037	1.6565
U.K.	1.4785	.6764

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